JUN 1 1943
CHARLES ELMORE CROPLEY
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM 1942

No. 1008

IN THE MATTER

of

PRUDENCE-BONDS CORPORATION,

Debtor.

IN THE MATTER of the Application of CHARLES H. KELBY and CLIFFORD S. KELSEY, as Trustees of the Debtor, and PRUDENCE-BONDS CORPORATION (New Corporation), for an order herein restraining and enjoining all parties to a certain action in the Supreme Court of the State of New York, New York County, entitled "Brooklyn Trust Company, as Trustee under the will of Susanna E. Coffin, deceased, Plaintiff, against President and Directors of the Manhattan Company; George E. Eddy; Hilda S. Reese; and Prudence-Bonds Corporation (New Corporation)," from taking any further steps and proceedings therein.

BROOKLYN TRUST COMPANY, as Trustee of a trust created in and by the will of Susanna E. Coffin, deceased,

Petitioner.

against

CHARLES H. KELBY and CLIFFORD S. KELSEY, as Trustees of the Debtor; PRUDENCE-BONDS CORPORATION (New Corporation); GEORGE E. EDDY; HILDA S. REESE; and PRESIDENT AND DIRECTORS OF THE MANHATTAN COMPANY,

Respondents.

REPLY BRIEF OF PETITIONER

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REPLY BRIEF OF PETITIONER

As to the Brief of Respondents Other Than Eddy

These respondents state that petitioner's statement of facts is inaccurate and incomplete. This is not true. Respondents have not pointed out in what respects it is not accurate or complete. That the debtor's trustees in 1938 assigned, transferred, and set over all of the right, title, and interest they had in the debtor's property to the new corporation is stated in the petition below of these very respondents (R. 53) so that our statement that the bankruptcy court surrendered control over it is not an assumption but is an uncontroverted fact.

The state court action, contrary to the impression respondents seek to create, was instituted for the purpose of judicially ascertaining whether petitioner and thousands of other former bondholders of the debtor similarly situated have individual causes of action for damages against the former trustees, based on their acts in surrendering some of the debtor's pledged collateral to it, and if the state court determines petitioner has a cause of action to have determined the damages to which it is entitled.

A determination in petitioner's action, whether in its favor or not, will not defeat any liability which may be established against a former trustee, but will declare and make certain the parties to whom such trustee is liable, which is a conceded matter of state law.

If the issues in petitioner's suit are, as respondents assert, misleadingly narrow (which petitioner denies), respondents, who are parties to such suit, may have the issues broadened and fully presented to the state court which they sedulously seek to avoid. The state court suit is not one between petitioner and Manhattan Company alone nor was it secretive. It was openly brought and all of the respondents except the debtor's trustees (who have been *functus officio* since the plans were consummated) *are parties to it and it is therefore in every sense adversary.*[1]

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[1] Petitioner could have brought an action against Manhattan Company alone. It could have submitted the question whether it has a cause of action against Manhattan Company for damages

(Footnote continued on next page)

Respondents were joined as parties to the state court action although no relief is sought against them not only so that they would be fully aware of it but to have an opportunity to present any defense or take any action therein they saw fit, or if they did not wish to be bound by a judgment therein to seek the discontinuance of the suit as to them.

The fact that respondents have been made parties to petitioner's suit and might be bound by *res judicata* is no more an interference with any jurisdiction of the federal court than if they were not parties to it, since the federal court will be obliged in either event to follow the decision in the State Court suit on this question of state law whether in petitioner's favor or otherwise.

Respondents have made no attempt to answer petitioner's claims (1) that the decision of the Circuit Court of Appeals to the effect that petitioner's suit and the accounting proceeding are *in rem* or *quasi in rem* and that petitioner's suit interferes with the jurisdiction of the District Court in the accounting proceeding is in conflict with state law and with the decisions of this court and of other circuit courts of appeals;[2] and (2) that the District Court,

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to the Appellate Division of the New York Supreme Court on an agreed state of facts. Petitioner deliberately made the new corporation and the bondholders Eddy and Reese parties to the state court action so that if the state court decided petitioner had a cause of action against Manhattan Company, they could not thereafter assert the action was fictitious and the decision need not be followed by the federal court although such assertion even in that event would lack merit.

[2] Such decision is also in conflict with the following decisions:

Browning v. *Fidelity Trust Company*, 3 Cir., 250 Fed. 321, cer. den. 248 U. S. 564, recognized the right of *an individual bondholder to bring an action in personam for damages* against a trustee under an indenture which secured the payment of the bonds for an unauthorized release of part of the mortgaged property.

Rheem v. *Allnut*, 64 F. 2d 548. The United States Court of Appeals for the District of Columbia held that when a trustee under a mortgage which secured the payment of notes wrongfully released the entire security so that it was lost, a holder of notes,

(Footnote continued on next page)

since the petitioner was not a party to the debtor's reorganization proceeding or to the accounting proceeding, had no jurisdiction to summarily restrain the prosecution of its suit. All they say is that such decision does not conflict with state law or the decisions of this court or of other circuit courts of appeal because it does not so conflict. Unable to meet petitioner's challenge, they have resorted to the unfounded claim that the state court suit is collusive although they do not dispute that petitioner had a legal right to sue Manhattan Company for damages in the state court.

We submit that the question of the character of the state court action is solely one for the state court to decide. *In each of the cases cited by respondents the court in which the action was brought or an appellate court in the same judicial system decided that question.*

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the payment of which was secured by such released property, *had an individual provable claim for damages against the trustee which was in bankruptcy.*

Young v. *Howard*, 120 F. 2d 712. This same court recognized a suit for damages by a receiver of a note-holder against trustees under a deed of trust for a wrongful release of the mortgaged property which secured the payment of the notes.

American Service Company v. *Henderson*, 4 Cir., 120 F. 2d 525. It was here held that where a corporate debtor acting as a fiduciary had actually converted trust res deposited with it and mingled it beyond identification with its own assets, the claim against it, based on such act, was one "in personam" which was extinguished by the debtor's bankruptcy reorganization proceeding, and it was not, as the claimant contended, an "in rem" claim to specific trust property.

The claims of the affected bondholders, based upon the acts of Manhattan Company in releasing pledged property to the debtor, are ones *in personam*, precisely the same as are those against a trustee *where trust res is lost* by his failure or neglect in collecting or insuring trust property; in selling it at an inadequate price; in making excessive expenditures; in depositing trust funds in a bank which he knows is in a precarious condition and which later fails; in permitting a co-trustee to have sole custody of the trust estate and its misappropriation by the latter; or in not disposing of speculative risks or wasting assets.

If this Court holds this question is properly here then it will be found to have been answered by this Court.

Dickerman v. *Northern Trust Co.*, 176 U. S. 181;
Freuler v. *Helvering*, 291 U. S. 35;
Blair v. *Commissioner*, 300 U. S. 5.

In the *Dickerman* case, a corporate mortgage provided the trustees might declare principal and interest immediately payable if any execution should be levied or sued out against the property of the mortgagor. A bondholder brought an action on six interest coupons. 'The action appears to have been brought directly or indirectly through the legal firm who were also counsel of the defendant company' (p. 189). A summons was issued and served on the president of the corporation who on the same afternoon appeared before a justice of the peace and consented to an immediate trial which resulted in a judgment for $180. Execution was issued at once and 'placed in the hands of the constable at about half past five o'clock of the same day'. Later the same day the trustees gave notice declaring the principal and interest due on all the bonds. 'It also appeared that the president of the company had been in consultation with the attorneys of the trustees about foreclosing the mortgage and taking possession of the property for several days prior to January 22', the day the action was commenced and expedited to its conclusion.

In a suit to foreclose the mortgage intervening stockholders of the corporate mortgagor filed an answer in which, *inter alia*, they alleged that the judgment and execution described above was a fraudulent and collusive act.

A master and all the courts before which the question was presented held the bondholder's action was not collusive. As shown by the opinion of this court the test is whether there is a real cause of action between the parties and, if there is, 'it is no defense that the plaintiff may have had some ulterior object in view beyond the recovery of the

judgment, so long as such object was not an unlawful one' (p. 190).

In *Freuler* v. *Helvering,* the Commissioner assessed a deficiency in income taxes against the beneficiary of a trust. The question was whether under the law of California the portion of gross income allocated for depreciation was distributable to the beneficiary. While an appeal from the deficiency assessment was pending before the Board of Tax Appeals the trustee, *for the first time in fifteen years,* filed an account in the state court which held that the life tenant must repay to the trustee the amounts which he should have reserved each year for depreciation. No appeal was taken from this decision. Thereupon the Board reversed the Commissioner, holding the decision of the state court conclusive. The Circuit Court of Appeals reversed the Board and this court granted certiorari.

An additional element in the case was the fact that after the decree in the state court the beneficiaries, instead of repaying the trustee the amounts found due him, gave their notes which were without interest and payable to the order of those who should be entitled in remainder at the termination of the trust.

The Commissioner suggested that the proceeding in the state court was collusive in the sense that all the parties joined in the submission of the issues and sought a decision which would adversely affect the Government's right to additional income tax. This Court held that the proceeding in the state court was not collusive, the opinion ending as follows:

> 'We cannot seize on the form of the settlement made between the parties either to impugn the good faith and judicial character of the state court's decree, or to ignore the decree and its conclusiveness as to what was in fact and in law income distributable to the beneficiaries under the trust' (p. 47).

This case is authority therefore that while a federal proceeding is pending it is not collusive to institute a proceed-

ing in a state court for the settlement of a question of law which will establish conclusively the law which the federal court must follow.

In *Blair* v. *Commissioner,* the beneficiary of a testamentary trust executed assignments of income in favor of his children. The Commissioner held the assignments invalid upon the ground that the trust was a spendthrift trust and assessed a tax on the entire income against the beneficiary. The Board of Tax Appeals reversed the Commissioner and was in turn reversed by the Circuit Court of Appeals (*Commissioner* v. *Blair,* 60 F. 2d 340) upon the ground that under the law of Illinois the income of the trust was not assignable and *certiorari was denied* (288 U. S. 602).

Just as in the present case *after denial of certiorari* a suit was then instituted in the state court for a construction and instructions. All the beneficiaries were joined *but no notice was given the Commissioner.* The assignments were held valid on an appeal to an intermediate appellate court of the state, no appeal being taken to the court of last resort.

At that time proceedings were pending before the Board of Tax Appeals to review assessments for later years. The Board received the record in the state court and, holding its decision conclusive, reversed the Commissioner. On appeal the Circuit Court of Appeals reversed the Board (*Commissioner* v. *Blair,* 83 F. 2d 655) and discussed the question of collusion in its opinion, putting particular emphasis on the fact that the Commissioner was not represented in and had no notice of the state court action (p. 657). This court reversed and dismissed the question of collusion in these words:

> 'Nor is there any basis for a charge that the suit was collusive and the decree inoperative. *Freuler* v. *Helvering, supra.* The trustees were entitled to seek the instructions of the court having supervision of the trust. That court entertained the suit and the appellate court, with the first decision of the Circuit Court of Appeals before it, reviewed the decisions of the

> Supreme Court of the State and reached a deliberate conclusion. To derogate from the authority of that conclusion and of the decree it commanded, so far as the question is one of state law, would be wholly unwarranted in the exercise of federal jurisdiction' (300 U. S. at p. 10).

The attitude of the state court upon this subject is shown in the recent decision in *Heyman et ux* v. *Heyman et al.*, 33 N. Y. S. 2d 235. There the plaintiff conveyed securities to himself and his wife as trustees for their son, with remainders to other children, all of whom were infants, retaining broad powers of control and management. The Board of Tax Appeals held the donor had power under the instrument creating the trust to revest the entire trust principal in himself and on that basis determined that a capital gain was taxable to him individually. The trustees then brought this action in the state Supreme Court for a construction of the trust instrument to which the infant beneficiaries were made defendants. On plaintiff's motion for judgment on the pleadings the United States, *which had not been made a party,* filed a brief as *amicus curiae* in which it was urged that the purpose of the action was merely to obtain a construction of the trust which it was hoped would help the plaintiff individually on an appeal from the decision of the Board of Tax Appeals. Mr. Justice VALENTE construed the trust instrument and held the action entirely proper and not collusive.

Against the principle established by these cases respondents present decisions involving an entirely different factual situation to support abusive characterization of certain parties to the state court action.

Lord v. *Veazie,* 8 How. 250, cited by respondents, involved a fictitious cause of action every element of which had been created by the parties for the purpose of instituting suit on it. In August Veazie executed an instrument purporting to convey stock of a railroad corporation to Lord. The instrument contained a covenant that the stock-

holders of the corporation had the right to use the waters of the Penobscot river for navigation. In September the action for breach of this covenant was docketed by consent and a statement of facts agreed upon by counsel for the parties. In October judgment was taken *pro forma*, the effect of which was to adjudicate that the stockholders had the right to use the river for navigation. The case was brought to the Supreme Court on writ of error. A motion was then made by Moor, who claimed the sole right to navigate the river under a statutory grant from the state legislature, to dismiss the appeal upon the ground that the case was fictitious and collusive and based on a feigned issue. This Court dismissed the writ, stating it was "satisfied, upon examining the record in this case, and the affidavits filed in the motion to dismiss, that the contract set out in the proceedings was made for the purpose of instituting this suit, and that there is no real dispute between the plaintiff and defendant" (p. 254). *The Court also rested its decision upon the fact that parties adversely interested had had no opportunity of being heard in defense of their rights* (id.).

Van Horn v. *Kittitas County*, 112 F. 1, was an action for breach of a contract on the part of the county to issue and sell bonds. The county had advertised for bids for the proposed bonds and plaintiff's assignors were the highest bidders. The county accepted the bid on condition that the bidders would cause a suit to be brought against the county and prosecuted to final determination in the supreme court of the state for the purpose of testing the validity of the bonds, the cost of the litigation, not to exceed $500, to be borne by the county. The bidders caused the litigation to be instituted and prosecuted to a final determination in the supreme court. The county then refused to deliver the bonds and sold them to another purchaser at a higher price. The court sustained a demurrer to the complaint holding the action in the state court collusive and saying:

> 'From the allegations of the complaint, and the necessary inferences to be drawn therefrom, the con-

> tract sued upon contained a condition precedent; that is to say, the county was not obligated to issue its bonds unless Farson, Leach & Co. should first be instrumental in causing litigation, and securing a decision of the supreme court of the state affirming the validity of the bonds. The agreement, therefore, was not divisable, and, as the only obligation of the county was made dependent upon performance of the condition by Farson, Leach & Co. the contract is entirely void if performance of the condition was unlawful' (p. 2).

The court then proceeded to hold the condition unlawful on the authority of *Lord* v. *Veazie, supra.*

Here, again, a contract was made for the purpose of instituting litigation to determine a pretended dispute between the parties.

Bell & Howell Co. v. *Bliss, et al.*, 262 F. 131, was a suit in equity for the infringement of a patent. Appellant made a contract with appellee Spoor granting him an exclusive right to use a machine that embodied a patent and agreeing to sell machines at a fixed price. Spoor defaulted on payments under the contract and appellant sued him and recovered judgment in a state court. As various later instalments came due and were unpaid similar actions were commenced. While these actions were pending Spoor paid the purchase price of another patent which was assigned to the appellee Bliss who then brought this action, joining Spoor as a defendant and alleging infringement. Spoor then filed a cross bill alleging his contract with appellant and asking an injunction restraining it from prosecuting its actions against him in the state courts. The court found it appeared from the report of a master that the second patent was acquired for the purpose of bringing suit and defeating and delaying appellant's actions in the state court, that appellee Bliss never had any interest in the patent or any connexion with the litigation and was ignorant of the contents of the bill. On this state of facts the court said:

> 'That this conduct is such as to justify a denial of all relief and a dismissal of the bill can hardly be

> seriously questioned. The conclusion that the present suit is for the sole purpose of hindering and delaying the proceeding in the state court is most amply supported by the testimony. Nor can the jurisdiction of the state court, upon the facts disclosed and for the relief sought, be questioned. The present suit, then, bluntly expressed, was but a means whereby Spoor, hardpressed in the state court, *using a dummy (Bliss) to conceal his own identity*, sought to do indirectly and deceptively what he could not do directly and openly—interfere with the orderly proceedings of the state court' (p. 134). (Italics supplied).

Again we have facts created for the purpose of litigation as distinguished from a preexisting right which a plaintiff contends is recognised by the state courts and which he wishes to vindicate in them.

Judson v. *Flushing Jockey Club*, 14 Misc. 350, was an action to recover a sweepstake. After a judgment for defendant the state racing commission and a number of racing organisations intervened on appeal and objected to argument on the ground that the action was fictitious and 'framed and propounded by a person who, in fact, is at once plaintiff and defendant'. The General Term of the New York Common Pleas ordered a reference to determine the facts.

Matter of V, 10 App. Div. 491, was a disciplinary proceeding against an attorney. He was charged, *inter alia*, with having caused a fictitious case to be prepared and submitted pursuant to section 1279 of the Code of Civil Procedure. Discussion of this charge is found at page 506 of the opinion.

Here, again, a contract was prepared and executed for the purpose of bringing suit.

The case of *United States et al.* v. *Johnson*, decided May 24, 1943, The United States Law Week, Volume 11, page 4420, is in no way factual or otherwise analogous to the case here; *contra*, this decision supports petitioner's claim that whether an action is collusive is a matter for deter-

mination by the court in which it is brought, or by an appellate court to which an appeal is taken from the decision of such court sustaining the action.

In the decisions in *Dickerman* v. *Northern Trust Co.*, *Freuler* v. *Helvering*, *Blair* v. *Commissioner* and *Heyman* v. *Heyman*, *supra*, where collusion is defined, it is established that the right to vindicate a preexisting right *in a state court* cannot be affected by the fact that in a proceeding pending in a federal court the decision of the state court will be conclusive. All the elements present here were present in the *Blair* case even to the commencement of the action in the state court after denial of certiorari by this court.

The decisions of this court which we have cited establish that the test of collusion is whether the cause of action existed before the 'ulterior object in view beyond the recovery of the judgment' (*Dickerman* v. *Northern Trust Co.*, *supra*) or the basis of the cause of action was created for the sole purpose of attaining the ulterior object.

> *May Hosiery Mills* v. *U. S. District Court*, 64 F. 2d 450, 453, et seq. *Wilmington W. R. Co.* v. *Board of Railroad Comrs.*, 90 F. 33, 37.

If the basis of the cause of action already existed and was not created *pro hac vice* then as in the present case the action is not collusive under the cases cited.

Assume for argument that Brooklyn Trust Company and Manhattan Company arranged to bring the action under attack for the ultimate object of obtaining a decision on a question of state law in conflict with that in *Manufacturers Trust Co.* v. *Kelby*. The acts of Manhattan Company upon which the action is based occurred several years before the objections to the accounts of the corporate trustees were filed in the debtor's reorganisation. Neither Brooklyn Trust Company nor Manhattan Company has done a single act designed for pleading in the complaint or answer. The estate of Susanna E. Coffin demands judg-

ment for damages against Manhattan Company payable by it personally out of its own funds for acts which these respondents themselves assert it did years before any ulterior object with which petitioner can now be charged could possibly have been conceived. Clearly respondents believe the Coffin estate has a valid cause of action despite the decision in *Manufacturers Trust Co.* v. *Kelby*, otherwise instead of striving so lustily to prevent its being decided in the court where it belongs they would contest the action.

The cases cited by respondents on page 7 of their brief are in no way apposite. Even if petitioner's suit in the state court were not one for damages but for a declaratory judgment for a judicial definition of its rights against Manhattan Company, it would under New York law have a constitutional right to maintain such action.

Re Brief of Respondent Eddy

Counsel for this respondent has submitted a brief which might be appropriate in the state court in the action which has been enjoined. Most of the brief is devoted to an argument that petitioner has no cause of action against the former trustee. That is the question for the state court, and the argument on this point is premature and is presented in the wrong forum. The question is not whether petitioner has a cause of action but whether it has the right to have that question determined now by the state court.

This respondent argues (which is not material here) that petitioner does not have a cause of action against Manhattan Company and at the same time inconsistently asserts that petitioner had a cause of action against the debtor because it acted jointly with the former trustee in withdrawing collateral and, therefore, concludes that petitioner was a party to the debtor's reorganization proceeding.

A party to a bankruptcy or to a bankruptcy reorganization proceeding is one whose claim has been judicially allowed. The allowance by the court in bankruptcy or reorganization of a party's claim is his admission into the

proceeding and without such allowance he is not in the proceeding and has no standing to in any way participate therein. There were never listed in the debtor's reorganization proceeding as creditors of the debtor its former bondholders who were not such bondholders at the time of the filing of its petition for reorganization, but who were such bondholders when the debtor made the withdrawals of collateral, nor were they ever classified; nor were any such claims which such former bondholders had against the debtor because of such withdrawals while they were bondholders, ever allowed. These parties consequently were never parties to the reorganization proceeding, nor to the subsequent accounting proceeding.

This respondent has conceded that the claims urged in the accounting proceeding are in personam and that there is no res over which the bankruptcy court has jurisdiction. (See footnote 5, main brief, page 25.)

The decision of the Circuit Court of Appeals is also in conflict with the rule established by the following decisions:

Even if the accounting proceeding of Manhattan Company in the District Court was assumed to be one in rem, the rule, however, is that the pendency of a proceeding in rem in one court does not preclude the granting in another court of *any* relief subsequently sought that does not conflict with the first court's control of specific property to which the jurisdiction in rem has attached. *Purcell* v. *Summers*, 4 Cir., 126 F. 2d 390, 395; *Wanamaker* v. *Eaves*, 4 Cir., 79 F. 2d 553; *Newberry* v. *Davison Chemical Co.*, 4 Cir., 65 F. 2d 724, 728; see also *Commonwealth Trust Company* v. *Bradford*, 297 U. S. 613, cited in main brief; *Watson* v. *Jones*, 13 Wall (80 U. S.) 679.

In *Wanamaker* v. *Eaves*, supra, the court held that the order of the federal court enjoining proceedings in the state court suit wherein some of the proceedings actually interfered with previously acquired jurisdiction of the federal court in a suit by a receiver of an insolvent national

bank to distribute property held by the bank should be modified so as to restrain the parties only to the extent of pursuing any remedies in the state court which would interfere with the jurisdiction of the federal court to hold, liquidate, and distribute assets brought under its jurisdiction *but not to interfere with the state court in passing on issues properly involved in the suit.*

The course which the Circuit Court of Appeals should have followed, even assuming arguendo only the accounting proceeding in the District Court were in rem or quasi in rem, is that prescribed by this Court in *Watson* v. *Jones*, 13 Wall (80 U. S.) 679, 720, i. e., *the state court, since control of any res by it is not essential to the maintenance of petitioner's action there,* should not have been restrained from granting any relief appropriate under the pleadings which would not interfere with any assumed specific property brought within the jurisdiction of the District Court, that is, *to decide whether petitioner has a cause of action against the former trustee.*

Meredith v. *City of Winter Haven*, 5 Cir., 134 F. 2d 202, 207, 208, holds that federal courts, although possessing jurisdiction because of diversity of citizenship, where the questions presented for decision are those of state cognizance, will not exercise their jurisdiction to determine such issues where the state court jurisprudence in regard to such questions is not definitely settled. Cf. *Burford* v. *Sun Oil Co. and Hastings* v. *Selby Oil & Gas Co.*, decided by this court on May 24, 1943, 11 U. S. Law Week, 4410.

May 28, 1943.

Respectfully submitted,

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